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Backgrounder

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Buried by a Falling Dollar: The Bank of Canada's Misguided Interest Rate Hike Promises Recession

by

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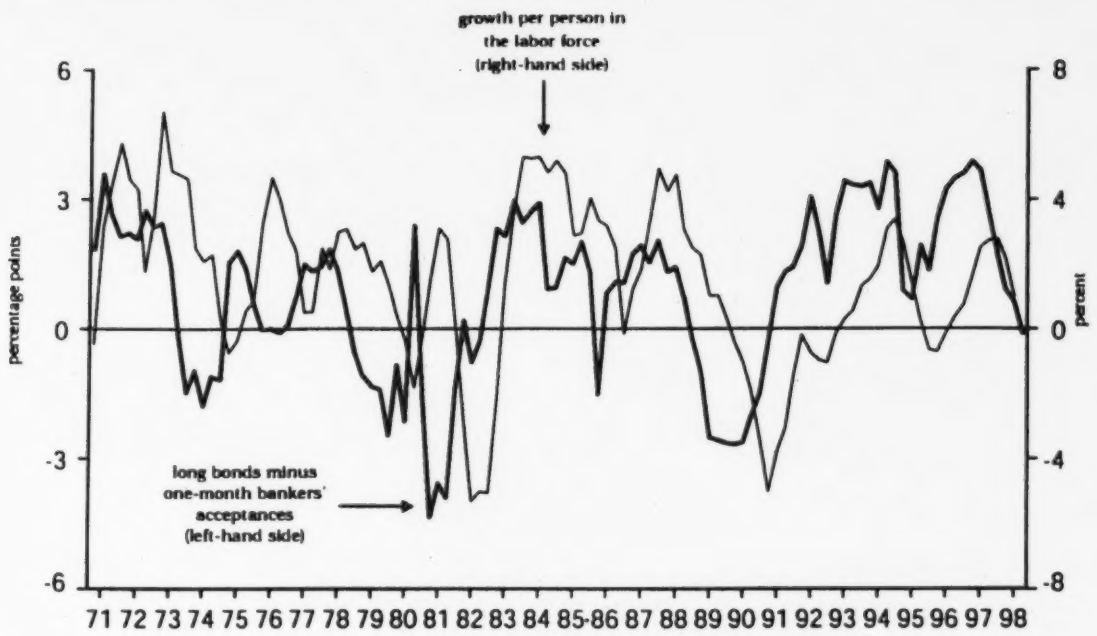
Until this morning, the Bank of Canada appeared to be succeeding in the hard but necessary job of limiting the impact of the weak Canadian dollar on monetary policy, focusing instead on the outlook for growth and inflation in the Canadian economy. The Bank's long-standing but misleading policy guide, the monetary conditions index — which made the exchange rate a key determinant of interest rate policy — seemed at long last to have been buried. Now, however, the one-percentage-point hike in the Bank Rate shows that the index still rules from the grave. Worse, it threatens to drag the Canadian economy under with it. If not reversed shortly, this latest rate hike all but guarantees a recession by year-end.

Even with the most enlightened monetary policy imaginable, the sliding dollar carries a somber message for Canadians. The deteriorating economic situation in Asia is weakening world demand for good and services. As a result, commodity prices are falling, putting pressure on Canada's resources sector. Russia's economic crisis is further unsettling world financial markets, a difficult environment for Canada and other countries that tend to rely on foreign borrowing. The weak Canadian dollar, like the sagging currencies of Australia, New Zealand, and Latin America, is the result of a normal reaction on the part of the world's investors to changing economic fortunes.

By reacting to the falling dollar with an interest rate hike, the Bank of Canada has taken a symptom of economic troubles and turned it into a cause of worse ones. Canada, like other countries that are seeing their currencies fall

Yield Curve and Growth, 1971–98



against the US dollar, will still lose international purchasing power. Instead of experiencing it mainly as a fall in the exchange rate, however, Canadians now risk suffering through a deflationary slump as well.

Like the rate hike at the beginning of the year — which optimistic observers saw as the monetary conditions index's last gasp — this latest boost spells trouble for the economy. The earlier rate hike sharply narrowed the spread between short- and long-term interest rates, a key link in the transmission of monetary impulses to the economy, slowing growth from a healthy pace then to a crawl now. Today's hike eliminates that interest rate spread entirely, flattening the yield curve, and raising the probability of a recession by early 1999 (see the figure).

The most frustrating thing about the Bank's misplaced focus is that the more it weakens the economy with its defense of the dollar, the worse the medium and long-term outlook for the dollar gets. Economic strength buoys currencies up; weakness sinks them. As the economy flagged in the wake of the interest rate increases of last December and January, the deteriorating outlook for investments in Canada helped reverse the dollar's bounce in the weeks immediately following the hikes, and accelerated its subsequent decline. This time, currency traders seem more aware of the ultimately self-defeating nature of a rate hike: the dollar's bounce was measurable in minutes, not days. Today's rate hike raises the chances that the dollar will continue to weaken through year-end.

By again putting the exchange rate front and center in its policymaking, the Bank of Canada has made its job harder, not easier. This latest interest rate hike has whetted the appetites of market players, who now expect another rate hike in the near future. If the Bank gives in again, a recession next year becomes all but certain, and the prospects for develop-

ments — strong business investment; broad-based tax cuts — that would reverse the decade-long slide of the Canadian dollar against the US dollar will fade to nothing.

Far better would be for the Bank to put stewardship of the domestic economy back in its proper place at the top of its concerns and bring short-term interest rates down again. It is time to bury the monetary conditions index for good. Better it than the Canadian economy.

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As with all C.D. Howe Institute publications, the views expressed here are those of the author and do not necessarily reflect the opinions of the Institute's members or Board of Directors. Kenneth J. Boessenkool is a Policy Analyst and William B.P. Robson is a Senior Policy Analyst at the Institute.

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